

December 2015

## WHAT YOU NEED TO KNOW ABOUT THE NEW SEC RULES ON CROWDFUNDING

On Oct. 30, 2015, the Securities and Exchange Commission (“SEC”) adopted new rules that will enable some private companies to use the Internet for crowdfunding campaigns seeking up to \$1 million per 12-month period.

The rules exempt crowdfunding offerings from traditional securities registration requirements under specific conditions to facilitate capital formation by smaller and startup companies. The SEC adopted the rules pursuant to the requirements of the Jumpstart Our Business Startups Act (“JOBS Act”). The SEC previously [proposed crowdfunding rules in October 2013](#) as outlined in our advisory.

The aptly named “Regulation Crowdfunding” rules will be effective May 16, 2016, but forms for registration of funding portals will be effective Jan. 29, 2016. The SEC published the lengthy (685 pages) rules and related analyses in [SEC Release No. 33-9974; 34-76324](#).

### PRACTICAL IMPACT

The new crowdfunding rules place significant SEC and FINRA filing and compliance requirements on companies looking to raise a relatively small amount of funding, and on the funding portals/broker-dealers through which the offerings will be conducted.

When the rules were first proposed in 2013, questions arose as to how many companies would avail themselves on the new rules once they were issued and effective. It may be that the burdens are too significant for many companies who could choose to utilize the traditional Regulation D Rule 506 private placements, including the newer Rule 506(c), which does allow certain types of general solicitation and advertising but for sales to accredited investors only.

Continue reading for a deeper look at some of the key provisions.

### INTERMEDIARIES ARE REQUIRED

For any exempt crowdfunding transaction, an issuer must use an intermediary – either a registered broker-dealer or funding portal – and can use only one intermediary at a time. The transaction will have to be conducted exclusively on the intermediary’s online platform.

### SOME ISSUERS ARE NOT ELIGIBLE

Many issuers are excluded from utilizing Regulation Crowdfunding, including the following issuers:

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Burns & Levinson’s Securities Law group represents public and private companies, underwriters and investment banks, venture capital and investment funds, real estate investment funds, investment advisors, broker-dealers, stockholder groups and individuals in public and private securities offerings and transactions, SEC, FINRA and stock exchange compliance, corporate governance, fund formation and offerings, SEC enforcement and securities litigation.

The group’s practical and proactive approach to understanding the rapidly changing securities disclosure and corporate governance laws enables them to provide clients with updates and guidance regarding specific situations in which clients may be impacted, and to implement the changes that are either required or advisable to comply with the new regulatory schemes and investor sentiment.

Our attorneys also represent underwriters in initial and follow-on public offerings and investment banks in private placements and mergers and acquisitions.

#### FOR MORE INFORMATION:

**Josef Volman** — Co-Chair  
617.345.3895 | [jvolman@burnslev.com](mailto:jvolman@burnslev.com)

**Andrew Merken** — Co-Chair  
617.345.3740 | [amerken@burnslev.com](mailto:amerken@burnslev.com)

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- Non-U.S. companies.
- Public companies subject to reporting requirements of the Securities Exchange Act of 1934.
- Investment companies or companies excluded from the definition of “investment company” only by Section 3(b) or 3(c) of the Investment Company Act of 1940.
- Companies that have failed to file required annual Regulation Crowdfunding reports during the two years preceding the filing of an offering statement.
- Companies subject to “bad actor” or other disqualification under Regulation Crowdfunding.
- Companies without a specific business plan or a plan to merge with unknown companies.

### LIMITS ON CAPITAL-RAISING BY ISSUERS

Rule 100(a) of Regulation Crowdfunding limits the aggregate amount sold by an issuer to all investors in reliance on the new exemption (in one or more offerings) to not more than \$1 million in the 12-month period preceding the date of sale. Any capital the issuer raises through other exempt transactions, such as Regulation A or Regulation D offerings, will not be counted in determining the aggregate amount sold.

### LIMITS ON INVESTMENTS BY INVESTORS

Under the final rules, an investor’s maximum purchase in a crowdfunding offering will be the greater of:

- \$2,000 or five percent of the lesser of the investor’s annual income or net worth for investors whose annual income or net worth is less than \$100,000.
- 10 percent of the lesser of the investor’s annual income or net worth, but not more than \$100,000 in purchases for investors with annual incomes and net worth each or \$100,000 or more.
- No investor may invest more than \$100,000 in any 12-month period across all such offerings.

For example, under this approach, an investor with annual income of \$50,000 and a net worth of \$105,000 is subject to an investment limit of \$2,500 (five percent of annual income). The existing Securities Act Rule 501(a) applicable to determining accredited investor status will govern the calculation of net worth and annual income.

### DISCLOSURE REQUIREMENTS FOR ISSUERS

The final rules require crowdfunding issuers to file certain information with the SEC and provide it to investors and the relevant intermediary for an offering. The required disclosures include, among other things:

- A description of the issuer’s business, number of employees and use of offering proceeds.
- Information about the issuer’s officers, directors and certain beneficial owners.
- Information about the offering and the securities being offered, including the price (or the method for determining the price).
- A description of related-party transactions and risk factors.
- A description of the issuer’s financial condition and current debt structure (similar to management’s discussion and analysis of financial condition and results of operations – MD&A) accompanied by specified U.S. GAAP compliant financial statements.

An issuer is required to amend its offering documents within five (5) business days of any material change to disclose material changes that occurred during the offering period and to provide specified updates regarding progress (including 50 percent and 100 percent commitments) toward reaching the target offering amount.

The issuer’s information must be posted on the intermediary’s platform for at least 21 days prior the sale of any securities (though investment commitments can be accepted) and throughout the entire offering period.

### FILING AND REPORTING REQUIREMENTS FOR ISSUERS

The final rules also require issuers to file with the SEC and electronically deliver to investors ongoing annual reports (Form C-AR) of the results of operations and relevant financial statements. The level of review of the financial statements will depend on the aggregate amount of securities offered by the issuer during the prior 12 months, including the current offering. They will have to be either certified by the issuer’s principal executive officer or prepared, reviewed or audited by an independent public accountant and filed no later than 120 days after the fiscal year covered by each report. However, quarterly reports or current reports as would be reported on an 8-K are not required.

## GENERAL RULES FOR INTERMEDIARIES

By statute and rule, all crowdfunding transactions will need to be conducted through a broker or funding portal. To be exempt from broker registration, funding portals must register with the SEC and FINRA. To maintain exempt status, funding portals must refrain from offering investment advice, soliciting transactions on the portal, handling investor funds or engaging in other activities proscribed by the SEC.

The final rules, unlike the proposed rules, will permit an intermediary to take a financial interest in a crowdfunding issuer but only if the interest is a form of compensation for crowdfunding services to the issuer and consists of the same securities being offered to others. Intermediaries will not be allowed to compensate any person for providing personally identifiable information about crowdfunding investors.

## INTERMEDIARY MEASURES TO PREVENT FRAUD

Rule 301(a) will require an intermediary to have a reasonable basis for believing that a crowdfunding issuer is in compliance with statutory and regulatory mandates associated with Regulation Crowdfunding, including record-keeping requirements.

An intermediary will be allowed to reasonably rely on representations of compliance from the issuer, unless the intermediary has reason to question the reliability of those representations. If an issuer has engaged the services of a transfer agent in an offering, the intermediary will be deemed to have a reasonable basis for assuming that adequate record-keeping compliance measures were taken.

If an intermediary has a reasonable basis for believing that an issuer or certain affiliated persons are subject to disqualification, the intermediary must deny the issuer access to its crowdfunding platform.

## TRANSACTIONAL REQUIREMENTS FOR INTERMEDIARIES

The rules will also require an intermediary to perform certain account opening duties, supply the SEC and investors with offering statement and disclosure information via electronic delivery, and provide on its platform effective channels for communication among investors and representatives of the issuer. An intermediary will also be required to give investors specific types of notices about an offering and a purchaser's rights in association with confirmations, cancellations and reconfirmations of securities purchases. Certain record-keeping and compliance rules will apply to an intermediary as well.

## INTERMEDIARY REGISTRATION RULES

An intermediary for a crowdfunding offering will have to register with the SEC as either a broker or a funding portal. The SEC is providing a streamlined process for registration of funding portals that is consistent with but less extensive than the process for broker-dealer registration.

A new Form Funding Portal will require information related to ownership and control of the portal, escrow and compensation arrangements, prior litigation, disciplinary history and other specified items. But unlike the proposed rules, the final rules will not require funding portals to have a fidelity bond.

## SAFE HARBORS FOR FUNDING PORTALS

Rule 402 of Regulation Crowdfunding provides a non-exclusive conditional safe harbor for certain specified activities of funding portals in connection with crowdfunding offerings.

For example, the safe harbor rule will allow funding portals to highlight multiple offerings according to specified objective and searchable criteria. The search criteria specifically cannot include any kind of investment opinion or analysis, management assessment or risk analysis. Funding portals will also be allowed to supply but not participate in channels for investor and issuer communications under specified conditions that will insure fair, open and transparent communications.

The SEC will provide a safe harbor for a funding portal to advertise its existence and identify its offerings under specified conditions, and it will allow a portal to advise issuers about the structure or content of an offering, and help issuers prepare offering documents.

Portals will also be allowed to pay third parties for referring a person to them, so long as the third parties do not provide personally identifiable information and the compensation is not based on a security transaction being completed. Under specified circumstances, a funding portal can pay for the services of registered broker or dealer in connection with a crowdfunding offering.

## RESTRICTIONS ON REALES AND TRADING

Securities issued in a crowdfunding transaction will not be transferable by an original purchaser for a one-year period unless transferred to the issuer, an accredited investor, a family member, certain related trusts, or as part of a registered offering.

## ADVERTISING RESTRICTIONS

Advertising the terms of the offering is not permitted, except for limited tombstone-type ad notices that direct potential investors to more information about the offering on the funding portal/broker-dealer's platform. These are similar to the tombstones permitted under Securities Act Rule 134. However, the rules do not prohibit how the notices can be distributed, so an issuer could place its notice in newspapers, as well as on social media sites and its own website.

## DISQUALIFICATION PROVISIONS

The rules will impose "bad actor" disqualifications that are aligned with the disqualifications applicable under other exempt offerings. Legal persons covered by the bad actor rules include the issuer and its predecessors or affiliates, the intermediary, specified control persons, certain promoters, compensated solicitors and their control persons ("Covered Persons").

Covered Persons involved in a disqualifying event, such as securities fraud or postal fraud, will not be allowed to play a role in, benefit from or conduct a crowdfunding offering. Though an issuer will not lose the benefit of a crowdfunding exemption if it is able to show that it did not know and with reasonable diligence could not have known of the existence of a disqualification. Disqualified persons can also seek a waiver of disqualification for equitable reasons.

## STATE BLUE SKY LAWS

Crowdfunding offerings are not required to conform to state registration/"blue sky" requirements, which are preempted by the SEC rules.

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### EXPLANATORY NOTES:

This update is intended to call your attention to various statements by the SEC of possible interest and relevance to you, but it is not intended to constitute a legal opinion or definitive summary of all interpretations and legal information that could be material to you. Please contact a member of the Securities Law practice at Burns & Levinson if you have any questions about these interpretive statements or if you want to learn more about our experience in this area.

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### OFFICE LOCATIONS:

Boston (HQ) | Andover | Hingham | New York | Providence | Waltham  
MA: 617.345.3000 NY: 212.231.2237 RI: 401.831.8330